82 - 1653

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

JAMES MITCHELL NEWMAN,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

ARTHUR F. MATHEWS *
LOUIS R. COHEN
MICHAEL R. KLEIN
ANDREW B. WEISSMAN
THOMAS W. WHITE
WILMER, CUTLER & PICKERING
1666 K Street, N.W.
Washington, D.C. 20006
(202) 872-6000
Counsel for Petitioner

* *Counsel of Record*

April 8, 1983

QUESTIONS PRESENTED

1. May a conviction of mail fraud be based solely on an employee's unauthorized use of confidential information learned in the course of his employment without any allegation that pecuniary harm was either contemplated or caused?

2. May a conviction of securities fraud under Section 10(b) of the Securities Exchange Act of 1934 be based, notwithstanding *Chiarella v. United States*, 445 U.S. 222 (1980), solely on the unauthorized use of nonpublic "outside" information, without any allegation that the defendant owed any duty of disclosure to any person who purchased or sold securities, or that any such person suffered pecuniary harm?

3. Did petitioner have fair notice that securities trading based on unauthorized use of nonpublic "outside" information was unlawful under federal law where pertinent judicial decisions and Securities and Exchange Commission pronouncements prior to his acts indicated such trades were lawful?

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES Page

TABLE OF AUTHORITIES—Continued

STATUTES AND REGULATIONS

TABLE OF AUTHORITIES—Continued

ADMINISTRATIVE RULINGS

MISCELLANY

TABLE OF AUTHORITIES—Continued

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

No.

JAMES MITCHELL NEWMAN,
Petitioner,
v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner James Mitchell Newman prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this case.

OPINIONS BELOW

The United States Court of Appeals for the Second Circuit affirmed petitioner's conviction of mail fraud, 18 U.S.C. § 1341, securities fraud, 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5, and conspiracy to commit mail fraud and securities fraud, 18 U.S.C. § 371. The court of appeals' order, which is unreported, is set forth in the Appendix ("App.") at 1a-3a. A previous opinion of the court of appeals arose on the United States' appeal of the dismissal of the indictment. The district court's opinion dismissing the indictment is set forth at App. 4a-39a. The court of appeals' opinion reinstating the indictment is reported at 664 F.2d 12 (2d Cir. 1981) and is set forth at App. 40a-54a.

JURISDICTION

Jurisdiction to review the court of appeals' February 8, 1983, judgment is vested in this Court by 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS AND REGULATION INVOLVED

The federal mail fraud statute, 18 U.S.C. § 1341, provides:

> § 1341. *Frauds and swindles*
>
> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both.

Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b), provides:

> § 78j. *Manipulative and deceptive devices*
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality

of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Securities Exchange Commission ("S.E.C."), 17 C.F.R. § 240.10b-5, provides:

§ 240.10b-5 *Employment of manipulative and deceptive devices.*

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

The decision below broke new ground in the law of both mail fraud and securities fraud. It held for the first time that the mail fraud statute encompasses an employee's unauthorized use of information belonging to his employer even if there was no intended or actual pecuniary loss to the employer. It also is the first decision finding civil or criminal liability under S.E.C. Rule 10b-5 for unauthorized use of nonpublic "outside" information by persons not alleged to have owed any duty to any party to a securities transaction or to the issuer of the securities.[1]

Petitioner James Mitchell Newman has been a professional securities trader for more than 10 years. During part of the period covered by the indictment, petitioner was employed as a securities trader and manager of the

[1] This case, like *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. S.E.C.*, No. 82-276 (argued March 21, 1983), involves the expansion of liability under Section 10(b) of the 1934 Act and S.E.C. Rule 10b-5 beyond its traditional scope. Because the court below extended Section 10(b) beyond its commonly understood prohibition against "insider trading" to proscribe trading while in possession of nonpublic "outside" information, it is crucial to understand the terminology used here and in the literature. "Inside" information is "nonpublic information that belongs to and emanates from the corporation whose securities are traded." Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1309 (1981). Inside information generally concerns the internal business affairs of the issuer. An "insider" is a person with a relationship to the issuer "affording access to inside information intended to be available only for a corporate purpose . . . ." *Chiarella*, 445 U.S. at 227. "Outside" information is "nonpublic information created by and belonging to sources outside the issuer." *Barry, supra*, at 1309. Outside information often is not about the internal affairs of the issuer, but may nevertheless be of interest to investors in its securities. *See also* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 329 (1979); Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility To Disclose Market Information*, 121 U. PA. L. REV. 798, 799 (1973); Koeltl & Kubek, *Chiarella and Market Information*, 13 REV. OF SEC. REG. 903, 904 (1980).

over-the-counter trading department of a securities broker-dealer; he later left to engage in trading for his own account.

Petitioner and three co-defendants, E. Jacques Courtois, Jr. ("Courtois"), Franklin Carniol, and Constantine Spyropolous,[2] were indicted for mail fraud, securities fraud, and conspiracy to commit mail, wire and securities fraud arising out of certain purchases of stock between 1974 and 1978. App. 55a-78a. The indictment charged that Courtois and Adrian Antoniu ("Antoniu"), an unindicted co-conspirator,[3] "misappropriated"[4] confidential information entrusted to their employers, Morgan Stanley & Co., Inc. ("Morgan Stanley") and Kuhn Loeb & Co. ("Kuhn Loeb"), by their respective clients regarding the plans of those clients to acquire other companies.[5] Since the information originated with the prospective acquirers rather than the prospective targets, it was "outside" information—information of interest to securities traders but not obtained from sources within the issuer. The indictment alleged that Courtois and Antoniu obtained such

[2] Courtois and Carniol reside outside of the United States and have not been extradited for prosecution under the indictment. After petitioner's conviction, Spyropolous entered into a plea bargain with the Government.

[3] Antoniu, apparently the central figure in the alleged conspiracy, entered into a plea bargain with the Government and cooperated in the prosecution of petitioner.

[4] Although the indictment uses the term "misappropriate," it does not allege that information was "taken" in the sense that its "owners" were deprived of that information. Instead, the indictment uses the term "misappropriation" as the equivalent of "misuse" of information, that is, use of information by employees in a manner contrary to that intended by their employers.

[5] Morgan Stanley and Kuhn Loeb are investment banking firms which, among other things, represented companies engaged in corporate mergers, acquisitions, tender offers, or other takeovers. App. 55a-56a. For convenience, they are sometimes hereinafter referred to together as the "investment bankers" or the "employers." Similarly, Courtois and Antoniu are sometimes referred to as the "employees."

information, that Antoniu communicated it to petitioner and others who purchased stock in the target companies, and that Courtois and Antoniu concealed these facts from their employers. Petitioner was the only person tried under the indictment.[6]

The indictment charged that by misappropriating information and failing to disclose the securities purchases to their employers the employees "violated and caused each other to violate the fiduciary duties of honesty, loyalty and silence which each owed" to the employers. App. 60a-61a. Petitioner and the others allegedly "aided, participated in and facilitated Courtois and Antoniu in violating" these fiduciary duties. App. 61a.

The indictment did not assert that Morgan Stanley, Kuhn Loeb, or any of their clients—the alleged victims of the fraud—suffered any economic harm, nor that the alleged scheme contemplated any pecuniary loss on their part. Nor did the indictment charge that any purchaser or seller of securities, or any other participant in any securities transaction, was misled, deceived or defrauded, or suffered any pecuniary loss. The indictment alleged only that petitioner aided two employees in their respective breaches of a duty owed their employers of honesty, loyalty and silence, and that he indirectly used the mails.

District Judge Haight granted petitioner's pretrial motion to dismiss the indictment. Judge Haight found: (i) the Section 10(b) counts failed to state a prosecutable offense because they alleged only a breach of duty owed to persons who were not securities purchasers, sellers or

---

[6] Another person who traded on the same information as petitioner, Bruce Steinberg, was not indicted and was advised by the Government that he had not committed any crime. Steinberg testified for the Government under a grant of immunity. Although he testified that he joined petitioner in the purchase of securities of target companies, he was twice told by the Government—on June 20, 1978, and again on April 15, 1981 (after several extensive interviews by prosecutors revealing his activities)—that the prosecution "is not presently possessed of information that Bruce Steinberg has committed a crime." App. 150a-153a.

investors, and such breaches of duty are governed by state law, not the federal securities laws (App. 25a); (ii) the theory of Section 10(b) liability pursued by the Government was so novel that it "does not charge Newman with acts that were proscribed by the securities laws then in force" (App. 27a); and (iii) the mail fraud counts failed to state a prosecutable offense because they were "devoid of any allegation of economic loss, actual or contemplated, on the part of the investment banks or their clients," and that without such allegations "[t]he conduct alleged in the indictment cannot be brought within the mail fraud statute without stretching its terms beyond the degree permitted by basic principles of criminal law." App. 37a-38a.

A divided panel of the Court of Appeals for the Second Circuit reversed the decision of the district court and remanded the case for trial. The majority held that the charges in the indictment "could be found to constitute a criminal violation of section 10(b) despite the fact that neither Morgan Stanley, Kuhn Loeb nor their clients was at the time a purchaser or seller of the target company securities in any transaction with any of the defendants." App. 44a. The majority also summarily rejected Judge Haight's dismissal on the ground of fair notice and due process. App. 49a-50a. The full panel reinstated the mail fraud counts, finding that: "The district court erred in holding that, in every mail fraud case based upon a breach of fiduciary duty by a private employee, there must be proof of 'direct, tangible, economic loss to the victim, actual or contemplated.'" App. 52a.

Following a five-week trial, petitioner was convicted of one count of conspiracy, seven counts of securities fraud and seven counts of mail fraud, all arising out of the breaches of duty by Courtois and Antoniu alleged in the indictment. Petitioner was sentenced to imprisonment for one year and one day, probation for three years thereafter, and a fine of $10,000. Petitioner's second appeal to the Court of Appeals reasserted his argument that the

indictment violated due process and failed to charge crimes under Section 10(b) and the mail fraud statute, and objected to the jury instructions which allowed a conviction under the theories pursued in the indictment. On February 8, 1983, the Court of Appeals for the Second Circuit affirmed petitioner's conviction. App. 1a-3a.

REASONS FOR GRANTING THE WRIT

I. THE DECISION BELOW RADICALLY EXTENDS THE FEDERAL CRIME OF MAIL FRAUD TO PRIVATE MISUSE OF INFORMATION WITHOUT ANY ACTUAL OR CONTEMPLATED PECUNIARY INJURY TO THE VICTIM.

This petition presents a novel and important question concerning the federal crime of mail fraud. The court below held that an employee's breach of his duty of "honest and faithful service" to his private employer constitutes mail fraud even if the employee neither intends nor causes economic injury to his employer. App. 52a.[7]

This Court declared long ago that mail fraud is "confined to pecuniary or property injury inflicted by a scheme to use the mails for the purpose." *Hammerschmidt v. United States*, 265 U.S. 182, 188-89 (1924).[8] This Court

[7] The Second Circuit's theory was well-stated in the district court's charge to the jury:

> "[I]t is not necessary, in a mail fraud case based upon a breach of fiduciary duty by a private employee, for the Government to prove direct, tangible, economic loss to the victim, actual or contemplated . . . Schemes designed to deprive its [sic] victims of intangible rights also violate the mail fraud statute." App. 123a.

The district court further charged the jury, in effect, that any deprivation of the employee's "honest services" was sufficient to convict. *Id.*

[8] A recent comprehensive examination of the language and history of the mail fraud statute likewise concluded that Congress intended to incorporate the common law rule that fraud was actionable only where the perpetrator intended to deprive the victim of his money or property. Comment, *The Intangible Rights Doctrine*

has never sustained a mail fraud conviction in the absence of such pecuniary harm.

Until recently, prosecutors and courts generally respected the limits on the mail fraud statute articulated in *Hammerschmidt.*[9] Over the past decade, however, prosecutions under the mail fraud statute have steadily expanded to cover an ever-wider range of activities not before subject to the federal criminal law. "In recent years, . . . the federal mail fraud statute . . . has been expansively interpreted to invite federal prosecution of virtually every type of untoward activity known to man." [10]

---

and Political Corruption Prosecutions Under the Federal Mail Fraud Statute, 47 U. CHI. L. REV. 562, 566-78 (1980). The statute proscribes a "scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises." 18 U.S.C. § 1341. The reference to "money or property" in one phrase does not mean that the term "scheme or artifice to defraud" encompasses non-pecuniary injuries. The "money or property" phrase was added in 1909, to codify the holding of *Durland v. United States,* 161 U.S. 306 (1896), that the statute extended to false promises, in addition to fraudulent misrepresentations of fact. *See* Comment, *Intangible Rights, supra,* at 570-72. Nothing in *Durland* suggests that the statute extends to schemes or artifices not involving actual or contemplated economic injury.

[9] *E.g., United States v. Regent Office Supply Co., Inc.,* 421 F.2d 1174, 1180 (2d Cir. 1970) (the Government cannot "escape the burden of showing that some actual harm or injury was *contemplated* by the schemer") (emphasis in original).

[10] Hurson, *Limiting the Federal Mail Fraud Statute—A Legislative Approach,* 20 AM. CRIM. L. REV. 423, 424 (1983). The pace and troublesome thrust of this recent trend is reflected in the volume and tenor of this and other recent learned commentary. *See, e.g.,* Coffee, *From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line between Law and Ethics,* 19 AM. CRIM. L. REV. 117 (1981); Rakoff, *The Federal Mail Fraud Statute* (pt. 1), 18 DUQ. L. REV. 771 (1980); Comment, *Intangible Rights, supra* note 8; Morano, *The Mail Fraud Statute: A Procrustean Bed,* 14 J. MAR. L. REV. 45 (1980).

The first step in this growth occurred in the area of public official corruption.[11] As Judge Friendly later stated, the "doctrine of the deprivation of honest and faithful services . . . developed to fit the situation in which a public official avails himself of his public position to enhance his private advantage, often by taking bribes." *United States v. Dixon*, 536 F.2d 1388, 1400 (2d Cir. 1976). This extension of the crime of mail fraud rested on the perception that public officials should be held to higher standards of conduct than other individuals: "No trustee has more sacred duties than a public official and any scheme to obtain an advantage by corrupting one must in the federal law be considered a scheme to defraud." *Shushan v. United States*, 117 F.2d 110, 115 (5th Cir.), *cert. denied*, 313 U.S. 574 (1941).

Prosecutors, particularly in the Second Circuit, soon attempted to extend these principles to *private conduct*. In the beginning they were unsuccessful. In *United States v. Dixon*, Judge Friendly recognized that the mail fraud statute did not encompass all violations of duty in the commercial context. He noted that while breaches of private fiduciary obligations violated the mail fraud statute when the purpose of the scheme was "to obtain direct pecuniary gain," a corporate officer's failure to make disclosures to shareholders mandated by S.E.C. rules was not actionable as mail fraud on the theory that the failure to disclose deprived shareholders of the officer's "honest and faithful services." 566 F.2d at 1399-1400.[12] Four years

[11] In *United States v. States*, 488 F.2d 761 (8th Cir. 1973), *cert. denied*, 417 U.S. 909 (1974), for example, a court of appeals for the first time upheld a mail fraud conviction where the only injury alleged was the deprivation of "intangible" political and civil rights. *States* was soon applied to other cases involving government officials. *E.g., United States v. Mandel*, 591 F.2d 1347 (4th Cir.), *on rehearing en banc*, 602 F.2d 653 (4th Cir. 1979) (per curiam), *cert. denied*, 445 U.S. 961 (1980); *United States v. Isaacs*, 493 F.2d 1124 (7th Cir.), *cert. denied*, 417 U.S. 976 (1974).

[12] The *Dixon* opinion noted that it was unnecessary to determine whether the principle of the political corruption cases that a show-

later, however, in a case involving an alleged *actual loss* to the victim of two million dollars, the Second Circuit declared in dictum that "the object of the fraudulent scheme need not be the deprivation of a tangible interest," but could include an employer's right to the honest and faithful services of his employees. *United States v. Von Barta*, 635 F.2d 999, 1006 (2d Cir. 1980), *cert. denied*, 450 U.S. 998 (1981). The Second Circuit the very next year held that a breach of fiduciary duty was actionable even though it was not causally related to the contemplated injury to the victim. *United States v. Bronston*, 658 F.2d 920 (2d Cir. 1981), *cert. denied*, 456 U.S. 915 (1982). Even in *Bronston*, however, the court recognized that the scheme at issue "was designed to inflict *actual economic harm* on [the victims] and was capable of doing so." *Id.* at 928 (emphasis added).

The line drawn in *Dixon* was abandoned in the present case. Here the Second Circuit upheld the conviction of a private citizen for aiding a purported "fiduciary breach" consisting solely of secret unauthorized use of information in violation of an employee's duty of "honest and faithful service" without requiring the jury to find any contemplated or actual pecuniary harm to the employer.[13] This

---

ing of economic harm was not necessary "should be carried over to the private field," *e.g.*, where an element of corruption, such as bribery, was involved. 536 F.2d at 1401.

[13] In cases involving kickbacks or other payments to employees by suppliers, the courts have invoked the deprivation of honest and faithful services rationale. *E.g.*, *United States v. George*, 477 F.2d 508 (7th Cir.), *cert. denied*, 414 U.S. 827 (1973); *United States v. Bryza*, 522 F.2d 414 (7th Cir. 1975), *cert. denied*, 426 U.S. 912 (1976). Those cases, however, involve economic injury to the employer because the scheme contemplates that the employer will be deprived of discounts that the supplier would presumably otherwise be willing to offer to the employer, but instead pays to the employee. *See United States v. George*, 477 F.2d at 513; *United States v. Bush*, 522 F.2d 641, 648 (7th Cir. 1975), *cert. denied*, 424 U.S. 977

case, in effect, federalizes and criminalizes as "fraud" any violation of a company policy, any employee peccadillo, so long as the bare jurisdictional requirement of a mailing is satisfied.

In marked contrast to this unrestrained lower court expansion of the meaning of "fraud" in the mail fraud context, this Court has in other contexts sought to define with some precision the boundaries of the concept of fraud in federal statutes. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that the federal securities law references to fraud incorporated the common law understanding that "fraud" actions require proof of scienter. Then, in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), a civil action, the Court rejected the notion that federal securities law fraud embraced every breach of duty touching a securities transaction—exactly the same breadth that the Second Circuit would now give the *crime* of mail fraud where there is any use of the mails.

If this Court is to prevent the trivialization of the criminal process, it must impose limitations on the mail fraud law akin to those imposed on civil actions under similar federal statutes. As this Court concluded in *Hammerschmidt, supra,* in the area of private conduct such limitations are found in the requirement of pecuniary harm.

(1976) (in kickback case, no need to express opinion on whether pecuniary injury must be shown to establish mail fraud violation, because pecuniary injury was present).

II. THE COURT BELOW IMPROPERLY RESOLVED THE ISSUE LEFT OPEN IN *CHIARELLA v. UNITED STATES* BY FEDERALIZING BREACHES OF DUTY WHOLLY WITHIN THE PROVINCE OF STATE LAW WHICH HAD NO EFFECT ON PERSONS INVOLVED IN SECURITIES TRANSACTIONS.

This petition presents the "misappropriation" issue expressly left open by this Court's recent interpretation of Section 10(b) of the 1934 Act in *Chiarella v. United States*, 445 U.S. 222 (1980). In *Chiarella*, the Court held that Section 10(b) does not impose a duty to "disclose or refrain from trading" on an individual who comes into possession of nonpublic information but is not a corporate insider and has no "special relationship" to the seller of securities.[14] The Court left open the question whether the individual's breach of duty to his employer—from whom he obtained access to material outside information—could provide the basis for a Section 10(b) conviction.[15]

---

[14] The Court said that "a purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts." 445 U.S. at 229. The opinion stated that a conviction required proof of a breach of a duty to disclose "arising from a relationship of trust and confidence between parties to a transaction." *Id.* at 230.

[15] The Court found that "[w]e need not decide whether this theory has merit for it was not submitted to the jury." 445 U.S. at 236. Chief Justice Burger, however, wrote in dissent that: "I would read § 10(b) and Rule 10b-5 . . . to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." 445 U.S. at 240. The prosecutors in this case, by focusing on a failure to disclose the misappropriation to the *employers*, pursued a misappropriation theory different from the Chief Justice's, which creates a duty to disclose to the *sellers* of securities information gained by means of misappropriation.

The Government framed the indictment in this case in order to test the issue left open in *Chiarella*.[16] Its theory below was that a breach of an employee's duty to *his employer*, not alleged to cause any harm to any person involved in a securities transaction, was nonetheless prosecutable under Section 10(b).[17]

A. The Rule Adopted Below Improperly Extends the Federal Securities Laws To Reach Conduct Traditionally Governed by State Law.

The breach of duty alleged by the Government involves only contractual or fiduciary obligations of employees to their employers, not duties created by the federal securities laws. The victims of the conduct—the investment bankers and their clients—were not involved in any of the securities transactions described in the indictment. *See* App. 44a.

The Government did not charge that the use of nonpublic outside information of impending takeover bids was itself unlawful. That is because under *Chiarella*, there being no relationship of trust and confidence between petitioner or the employees and the sellers of secu-

---

[16] For this reason, the decision below has been the subject of considerable commentary. *E.g.*, Note, *Trading On Confidential Information—Chiarella Takes An Encore: United States v. Newman*, 56 ST. JOHN'S L. REV. 727 (1982); Recent Developments, 27 VILL. L. REV. 1329 (1982); Note, 13 SETON HALL L. REV. 178 (1982); Recent Decisions, 58 NOTRE DAME L. REV. 132 (1982).

[17] Accordingly, the jury was charged by the district court as follows:

> "The Government does not charge in this case that the persons from whom Mr. Newman purchased stocks in the target company were themselves defrauded. . . . This indictment charges that Mr. Newman and the other individuals referred to defrauded, not the sellers of the target companies' stock but rather Morgan Stanley, Kuhn, Loeb and their corporate clients." App. 120a-121a.

rities, petitioner had no duty to disclose material non-public information or refrain from trading. *See* 445 U.S. at 228. Petitioner's prosecution rested solely on the allegation that the use of this information for securities purchases had not been authorized by the employers, and that his colleagues had failed to disclose that use to them. *See* App. 137a. No person engaging in a securities transaction was alleged to have been misled by this breach of duty to the employers; there was no contention that had there been disclosure of the unauthorized transactions to the employers, any market trade would have been affected.

The misappropriation of information alleged here is the type of conduct that traditionally has been the province of state law governing employee-employer relationships and commercially sensitive information. The rule adopted below would change this. It would impose, under Section 10(b), a federal securities law standard of conduct for such matters.[18] The federalization of these relationships merely because after the alleged breach of duty the information was used in otherwise lawful securities transactions is clearly beyond the intended scope of the securities laws.

This Court declared in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), that even breaches of fiduciary duty directly affecting securities transactions registered under the 1934 Act do not constitute violations of Section 10(b) when the breach is of a type that falls within the traditional framework of state law. In *Santa Fe*, the Court reasoned that applying Rule 10b-5 under these circumstances "would be to bring within the Rule a wide variety of corporate conduct traditionally left to

---

[18] *See* Note, *Trading On Confidential Information—Chiarella Takes An Encore: United States v. Newman*, 56 ST. JOHN'S L. REV. 727, 735 (1982) ("the Second Circuit has transformed an employee's fiduciary obligations into the status of a new federal securities law duty").

state regulation," and that "the extension of the federal securities laws would overlap and quite possibly interfere with state corporate law." 430 U.S. at 478-79. Accordingly, "[a]bsent a clear indication of congressional intent," the Court was "reluctant to federalize" state corporation law, "particularly where established state policies of corporate regulation would be overridden." *Id.* at 479.[19]

The *Sante Fe* decision has direct application here. The conduct at issue here involves matters traditionally governed by state law—here the law of the State of New York. The court below circumvented the limitations of state law[20] by adopting the strained theory that Section

---

[19] The district court's original dismissal of the indictment relied in part on this point. The court stated:

> "While the acquiring corporations and investment bankers were damaged . . . insofar as they were deprived of their agent's duty of loyalty and ethical behavior, they were not damaged in their role as future investors in the target companies. While injury of the latter type falls generally within the domain of federal law, the former category is more appropriately governed by state law." App. 25a.

[20] The New York Penal Law makes it unlawful (1) to engage in a course of conduct with intent to defraud persons or to obtain property from persons by false or fraudulent pretenses, *and* (2) to obtain property by such means from these persons. N.Y. Penal Law § 190.60 (McKinney 1982 Supp.). It is unlikely that the employees violated this or any other New York Penal Law governing theft of property because they did not "obtain property" as defined under the statute, nor did they intend to "deprive" the employers of property as required to commit larceny. *See* N.Y. Penal Law §§ 155.00(1), (2), (3), 155.05, and 165.07 and comments thereon (McKinney 1975). Neither would the employees' alleged breach of duty constitute actionable civil fraud. *See, e.g., Mallis v. Bankers Trust Co.*, 615 F.2d 68, 80 (2d Cir. 1980); *Morrison v. National Broadcasting Co.*, 266 N.Y.S. 2d 406, 410 (S. Ct. 1965), *rev'd on other grounds*, 280 N.Y.S. 2d 641 (1967). The investment bankers and their clients could, of course, pursue state law causes of action other than fraud or deceit, including claims for breach of contract or an equitable accounting for profits obtained through the use of confidential corporate information. *See, e.g., Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910 (1969).

10(b) applied because the "proceeds" of the employees' misappropriation—information—were used to determine which securities petitioner bought. In so holding, Judge Van Graafeiland, writing for a divided panel, reversed the district court's finding "that fraud perpetrated upon purchasers or sellers of securities is a 'requisite element under the securities laws.'" App. 46a.[21] Citing this Court's decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1972), the majority ruled that any fraud on a person not engaged in securities trading becomes a Section 10(b) violation if the fraudulent activity "touches" upon the purchase or sale of securities. App. 48a-49a. This conclusion both misconstrues *Superintendent* and ignores this Court's subsequent admonitions in *Santa Fe* against federalizing state law.[22]

In *Superintendent*, this Court found Section 10(b) liability where a seller of Government bonds was "duped" through deceit by its fiduciary into making a sale because it was fraudulently misrepresented that the seller would receive the proceeds. 404 U.S. at 9. Liability attached in *Superintendent* because the seller "*was injured as an in-*

[21] Judge Dumbauld dissented from this aspect of the court's opinion, noting "a trend to confine the scope of § 10(b) to practices harmful to participants in actual purchase-sale transactions." App. 53a.

[22] Judge Van Graafeiland also erred by equating the alleged misappropriation with fraud. Pressed by this Court's statement in *Chiarella* that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud," 445 U.S. at 234-35, he assumed without discussion that an employee's misuse of confidential corporate information, like embezzlement of corporate property, was fraud. App. 46a-47a. But this Court made it clear in *Santa Fe* that the term "fraud" in Rule 10b-5 cannot be used "to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction." 430 U.S. at 472. The acts of the employees in this case were at most—even if they had fiduciary rather than mere contractual obligations—breaches of fiduciary duty.

vestor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities." *Id.* at 10 (emphasis added). The Court concluded that "[t]he crux of the present case is that [the seller] suffered an injury as a result of deceptive practices touching *its sale of securities as an investor.*" *Id.* at 12-13 (emphasis added). Clearly, *Superintendent* did not set forth an expansive "touch" test of the type adopted by the Second Circuit here. Nor does it otherwise support a finding of Section 10(b) liability where, as in this case, the Government scrupulously avoided any allegation that the fraud ever deceived any person with an investment interest or participation in the securities transactions that followed the alleged misappropriation.[23] Indeed, neither this nor any other court has ever held Section 10(b) applicable where the victim did not participate in, or have any investment interest in, an affected securities transaction.[24]

[23] *See* Recent Developments, 27 VILL. L. REV. 1329, 1346 (1982) ("a careful reading of [*Superintendent*] indicates that the fraud must result from deceptive practices 'touching' the purchase or sale of securities *of the defrauded party*") (emphasis in original).

[24] *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737-38 (1975); *United States v. Naftalin*, 441 U.S. 768 (1979). In *Naftalin*, referenced by the court below (App. 49a), this Court reaffirmed the view that a prerequisite for "securities" fraud is deceit of a person in connection with his or her participation in securities trading, when it held that Naftalin violated Section 17(a)(1) of the Securities Act of 1933 because the terms of the statute were "expansive enough to encompass the entire selling process, including the seller/agent transaction." 441 U.S. at 773. *See also Ketchum v. Green*, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977); *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 659 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974) (opinion of Stevens, J.); *Vincent v. Moench*, 473 F.2d 430, 434-35 (10th Cir. 1973); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971) (Congress intended Section 10(b) to apply to deceit "of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities").

In sum, the rule of law adopted below gave Section 10(b) and Rule 10b-5 unprecedented breadth to cover conduct traditionally governed by state law. This Court should review the fundamental question it raises regarding the appropriate scope of federal securities fraud prosecutions.

B. Determination of the Validity of the Government's "Misappropriation" Theory Is Vital to the Securities Industry.

The Government's contention is that "a stock purchase on misappropriated information is in itself a form of fraud and deception as against the rightful owner of the information" creating liability under Section 10(b) and Rule 10b-5.[25] That theory represents a broadening of Section 10(b) liability which is of grave import to the securities industry. The concept of the misuse of information can be so elusive, both in the definition of information covered and the determination of its appropriate use, that the expansion of Section 10(b) liability on the misappropriation theory could have the counterproductive effect on the securities industry of chilling legitimate and productive information-gathering activities.

In the normal course of their employment, many persons in the industry routinely have access to nonpublic outside information. Investment bankers, for example, gain access to information in the course of providing professional services relating to the full range of corpo-

---

[25] *See* Brief for the United States of America in *United States v. Newman*, Docket No. 81-1225, at 27. *See also Tender Offers*, Sec. Exch. Act Rel. No. 6239, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82646 at 83456 (Sept. 4, 1980) (". . . persons who unlawfully obtain or misappropriate material, nonpublic information violate Rule 10b-5 when they trade on such information"). The Court of Appeals for the Second Circuit has adopted this theory. *See* App. 44a; *United States v. Chiarella*, 588 F.2d 1358, 1368 n.14 (2d Cir. 1978), *rev'd on other grounds*, 445 U.S. 222 (1980).

rate finance transactions.[26] Likewise, the job of securities analysts is constantly to seek nonpublic information regarding publicly-traded companies. Often they gather it by pressing company personnel and other industry sources for nonpublic news of general applicability or pertaining to the prospects of particular businesses. Such research is crucial to the effectiveness of the securities marketplace. Their inquiries are hardly limited to information of potential or impending takeover efforts, as in this case. Other areas of obvious interest include such information as changes in the levels of orders for certain products or services; price forecasts for various commodities; impending awards of major commercial contracts; changes in key personnel; breakthroughs in research and development; and so forth.[27] In addition to such analysis, the market role of some persons *requires* that they trade on nonpublic outside information, *e.g.*, the stock exchange specialist. *See Chiarella, supra*, 445 U.S. at 233-34 n.16.

The Government's misappropriation theory, particularly when applied in a prosecution for aiding and abetting,

---

[26] *See Walton v. Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980), where it was held that an investment banker may trade on nonpublic *inside* information obtained at arm's length from the issuer.

[27] *See* Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1314 n.43 (1981):

> "Corporations, their associates, and their employees continuously create or receive from countless outside sources information that may affect dramatically the fortunes of competitors, customers, and suppliers. Advance information accessible to even the itinerant salesman about new products, new contracts, accidents, bankruptcies, and other events may have great value to someone trading in the stock of companies only indirectly affected."

Accord, Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 331 (1979).

creates a new risk of prosecution for securities analysts, specialists and other professional traders performing their proper role in the market: ascertaining, disseminating, and utilizing market information.[28] By creating disincentives for these activities, a rule of this breadth could seriously impair the ability of market intermediaries to disseminate pertinent market information. It should be reviewed by this Court before it has widespread application.

III. PETITIONER'S CONVICTION VIOLATES DUE PROCESS OF LAW BECAUSE HE WAS INDICTED AND CONVICTED UNDER SECTION 10(b) FOR CONDUCT NEVER BEFORE HELD TO BE A CRIME, AND AT THE TIME REASONABLY BELIEVED TO BE LAWFUL.

District Judge Haight, declaring that "man's free choice must be guided and informed by legislative prohibitions which are clear, definite and precise" (App. 9a-10a), initially dismissed the indictment against petitioner because "there was no 'clear and definite statement' in the federal securities laws which both antedated and proscribed the acts alleged . . . ." App. 25a. In so concluding, Judge Haight took special note of *Chiarella*, in which, as noted above, this Court made clear that the "misappropriation" theory, under which petitioner was subsequently indicted and convicted, represented a novel ap-

---

[28] The S.E.C. stated in *In re Dirks*, Sec. Exch. Act Rel. No. 17480, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,812 at 83,945 (Jan. 22, 1981), *aff'd*, 681 F.2d 824 (D.C. Cir. 1982), *cert. granted*, 103 S. Ct. 371 (1982), that securities analysts "actively seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients who, in turn, can be expected to trade on the basis of the information conveyed. The value to the entire market of these efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by such efforts to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors."

plication of Section 10(b) the propriety of which was expressly not addressed by the Court. App. 10a-11a.[29] Justice Stevens, while agreeing that the Court should not reach the issue, found that "[r]espectable arguments could be made in support of either position" for or against the criminal application of Section 10(b) to an employee's breach of the duty of silence owed to his employer. 445 U.S. at 238.

The Court in *Chiarella* also responded to Justice Blackmun's dissenting argument for adoption of a broad standard of liability for trading on nonpublic outside information as follows:

> "[A] judicial holding that certain undefined activities 'generally are prohibited' by § 10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity. *Cf. Grayned v. City of Rockford*, 408 U.S. 104, 108-09 (1972)." 445 U.S. at 235 n.20.[30]

Grayned is but one of many cases which uniformly hold that penal statutes not providing reasonable notice to men of common intelligence of the unlawfulness of their acts violate the fundamental constitutional guarantees of due process.[31] Under this same standard, novel

---

[29] In *Chiarella*, because "[t]he jury was not instructed on the nature or elements of a duty owed . . . to anyone other than the sellers," this Court declined to "speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10(b)." 445 U.S. at 236-37.

[30] The Court also took note of the fact that Chiarella's prosecution was "apparently the first case in which criminal liability has been imposed on a purchaser for § 10(b) nondisclosure." 445 U.S. at 235 n.20. After the Court's reversal in *Chiarella*, petitioner stands in Chiarella's position as a test case for a new Government theory of Section 10(b) criminal liability.

[31] In *Grayned*, the Court declared that "[i]t is a basic principle of due process that an enactment is void for vagueness if its prohibitions are not clearly defined . . . [B]ecause we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a rea-

applications of valid statutes to new and unpredictable circumstances equally transgress the due process requirement of fair notice of illegality.[32]

Petitioner, of course, was indicted and convicted for stock purchases which occurred between 1974 and 1978, well before the Court's introduction to this novel issue in *Chiarella*, and well before any court had found Section 10(b) applicable to trading on misappropriated outside information.[33] Indeed, to this date the only court that

---

sonable opportunity to know what is prohibited, so that he may act accordingly." 408 U.S. at 108. *Accord, Dunn v. United States*, 442 U.S. 100, 112-13 (1979); *United States v. Harriss*, 347 U.S. 612, 617 (1954); *Lanzetta v. New Jersey*, 306 U.S. 451, 453 (1939); *Connally v. General Construction Co.*, 269 U.S. 385, 391 (1926).

[32] *See Bouie v. City of Columbia*, 378 U.S. 347, 350 (1964). The due process issue is not, as the S.E.C. argued in its *amicus* brief to the Second Circuit, whether or not petitioner or his alleged co-conspirators knew that their conduct was on the borderline of the law and therefore took actions to maintain the secrecy of their activities. *See* Brief for the Securities and Exchange Commission, *Amicus Curiae*, Docket No. 81-1225 at 12-13 (June 29, 1981). This Court wrote in *Bouie* that "[t]he determination whether a criminal statute provides fair warning of its prohibitions must be made on the basis of the statute itself and the other pertinent law, rather than on the basis of an *ad hoc* appraisal of the subjective expectations of particular defendants." 378 U.S. at 355-56 n.5.

[33] Previous judicial pronouncements on the issue of "insider" trading reflected, if anything, a general view that petitioner's trading on nonpublic *outside* information did not constitute a Section 10(b) violation. *See General Time Corp. v. Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969) ("We know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale"); *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972) ("The essential purpose of Rule 10b-5, as we have stated time and again, is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsider"); *SEC v. Great American Industries, Inc.*, 407 F.2d 453, 460 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 920 (1969) ("to read Rule 10b-5 as placing an affirmative duty of disclosure on persons who in contrast

has approved this application of Section 10(b) is the Second Circuit Court of Appeals when it decided petitioner's appeal. Moreover, as Judge Haight's district court opinion explained at some length, contemporaneous analyses of the law in this area by the securities bar and even the S.E.C. itself during the years preceding petitioner's purchases reveal that no one then contemplated that trading on material nonpublic outside information was prohibited by Section 10(b). *See* App. 15a-25a. It was not until 1980, after a decade of consideration, that the S.E.C. prohibited the conduct addressed in petitioner's indictment. *See* 17 C.F.R. § 240.14e-3.

Based upon these considerations, the district court concluded that:

> "[T]here was no 'clear and definite statement' in the federal securities laws which both antedated and proscribed the acts alleged in this indictment. As of the times alleged, neither courts, commentators, nor the SEC in its rule-making or enforcement capacities had stated that Rule 10b-5 extended to a noninsider's breach of a fiduciary duty owed to the acquiring corporation in a tender offer. To the extent the question was addressed at all, the indications . . . were quite to the contrary. While the SEC has concerned itself with the general subject of tender offers at least since the enactment of the Williams Act in 1968, the conduct sought here to be prosecuted was not proscribed until 1980, when Rule 14e-3 was promulgated. Prior to that time, the absence of such a rule, particularly when viewed in the context of the SEC's inquiry to the industry as to whether one should be adopted, precludes criminal prosecutions for what is, in effect, unproscribed conduct." App. 25a.[34]

---

to 'insiders' or broker-dealers did not occupy a special relationship to a seller or buyer of securities, would be occupying new ground and would require most careful consideration").

[34] *Compare United States v. Chiarella*, 588 F.2d at 1376-77 (Meskill J., diss.).

The court of appeals barely addressed the key due process issue raised in Judge Haight's district court opinion. Its sole discussion of the issue of fair notice was its conclusory finding that "Rule 10b-5's proscription of fraudulent and deceptive practices upon any person in connection with the purchase or sale of a security provided clear notice to appellee that his fraudulent conduct was unlawful." App. 49a-50a.

In view of the cursory consideration apparently given this issue by the court of appeals, and petitioner's impending imprisonment, this Court should grant certiorari to provide review befitting the grave issue of due process of law that is presented.

CONCLUSION

For the reasons set forth above, certiorari should be granted to review the judgment of the court of appeals.

Respectfully submitted,

ARTHUR F. MATHEWS *
LOUIS R. COHEN
MICHAEL R. KLEIN
ANDREW B. WEISSMAN
THOMAS W. WHITE

WILMER, CUTLER & PICKERING
1666 K Street, N.W.
Washington, D.C. 20006
(202) 872-6000

Counsel for Petitioner

* *Counsel of Record*

April 8, 1983